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December 2011

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Economies in Europe and North America are struggling to avoid another recession. Financial markets are shaky. Uncertainties overhang businesses as policy makers in both regions wrestle with nettlesome issues like government debt and regulatory models. In a troubled economic environment, it would be easy to assume the private equity (PE) industry is on the ropes.

In fact, the industry continues its post-recession recovery, and private equity portfolios have outperformed public markets, a development largely attributed to the ability to create value during tough economic cycles as well as good ones. While the industry has suffered its share of setbacks, its recovery during the recession demonstrates that PE continues to represent a good option for investors seeking solid long-term returns, though perhaps not as solid as in the past.

"We had quite a peak-to-trough cycle," says Jeff Bunder, global private equity leader at Ernst & Young (EY). Despite that, a deep look at the industry, reported in two new EY studies, shows PE has been remarkably resilient. "It's one of those things that's kind of hard to believe – it's not intuitive."

Clearly, conditions remain far from ideal. "Though the pace of exits has improved, it remains well below its peak levels," says Harry Nicholson, EY's commercial advisory services leader in Europe, Middle East, India and Africa, who led the two studies. In Europe, for example, the value of exits for 2010, about 60 billion euros, was only half what it should have been given the size and age of the industry's portfolios. "The health of the private equity industry clearly rests on a good level of both buying and selling.... there's still a long way to go to get there relative to some of the current portfolios."

A Challenging 2012

Though conditions improved in 2010 and through the first half of 2011, a disappointing economic background, government credit issues in Europe and the United States and volatile financial markets make for a challenging environment for private equity in 2012, according to Stephen M. Sammut, a lecturer at Wharton and partner at Burrill & Company, a venture capital, PE and merchant banking firm based in San Francisco.

"I think the upcoming years are going to be very difficult in North America and in Europe, for a couple of reasons," he says. Credit tightening is likely to make leverage "such as it has been, tighter and perhaps more costly."

The private equity industry has matured, making the outsized returns of the past difficult to duplicate says Bulent Gultekin, a finance professor at Wharton who teaches a course on private equity. "Like everything

else, over time as a product or industry becomes successful, and when there are no entry barriers, many people enter the industry and it becomes quite crowded," he says, noting this will obviously make it harder for PE firms to find bargains for their portfolios. "There will be pressure on returns.... The easy ways of making money are pretty much done."

The two EY studies, sharing the title "Return to Warmer Waters – How do Private Equity Investors Create Value?" found that successful private equity firms in Europe and North America have adapted to difficult conditions by placing greater emphasis on improving management of portfolio firms while reducing reliance on once-common techniques such as financial engineering.

"When the economy turned south, they got actively involved," Bunder says.

The annual studies, which have been conducted for six years in Europe and five in North America, found that PE investments have proven successful even in the worst of times. "The thaw in the market in 2010 was driven by a renewed appetite among PE investors for good-quality businesses, bolstered by a greater availability of acquisition finance, as exits via secondary buyouts nearly doubled by volume in our sample over the previous year," the North American study noted.

"The gross returns achieved by all PE exits between 2006 and 2010 are three times those achieved on public markets," the European study summarized, noting that PE outperformed comparable public companies on "value drivers" such as EBITDA (earnings before interest, taxes, depreciation, and amortization), growth, employment growth, productivity growth and valuation multiples.

Performance Drives Gains

While PE firms benefitted from the rebound of the public markets, the European study found that 40% of the gross investment return on PE exits came from outperformance, or gains in excess of additional leverage and market returns.

What drove performance?

"We found confirmation of what we had been hearing anecdotally: Organic revenue was the largest driver of profit growth, accounting for 46% of the total across the whole period of our research," the European study summarized, noting that this factor was even more significant in 2010.

The North American study came to similar conclusions, adding that: "Fifty-seven percent of returns generated by PE between 2006 and 2010 can be attributed to PE's value-add, with operational improvement driving the majority of value creation, rather than multiple expansion and additional leverage." More than 40% of EBITDA growth was attributed to revenue growth, 30% to cost reductions and 20% to add-on acquisitions.

Key to the outperformance were PE firms' efforts to create fundamental changes in portfolio companies, including initiatives to drive geographical expansion, improve sales, introduce new products and refine pricing. Emphasis on operational improvements became more of a focus as PE firms found it more difficult to earn profits through exits. "There was no buying and selling to be done, so everyone was focused on the portfolio, which is exactly what they should do," Nicholson says.

Rather than being a temporary response to recent economic conditions, the focus on operational improvements is likely to be sustained, according to Sammut. "Funds are going to have to be more judicious and will likely have to rely on less leverage, and as a result will have to focus more on operational redesign of their portfolio companies, as opposed to financial engineering." Gultekin agrees: "It's not going to be that easy to buy companies on the cheap. Then, when they are sold, it's not going to be easy to sell at outrageous multiples."

Bunder notes that many middle-market firms are starting to incorporate practices recently embraced at larger firms, such as adding operational support, suggesting that operational focus is likely to emerge as an industry standard.

To implement operational improvements, the studies found, it is essential to have the right management in place when a portfolio firm is acquired. Management shake-ups afterward add an average of 1.6 years to the holding period in Europe and up to two years in North America. "As we find year to year, backing the right management team from the outset of the investment is paramount," the North American study found, adding that, "Enhancing and expanding the management team has become a more vital part of the PE's active ownership model than in the past."

100-Day Plans

It is now standard practice, for example, for PE firms to use 100-day plans to execute change quickly, the study noted. "The use of 100-day plans was more prevalent when cost control initiatives were being implemented and their use also correlated to outperformance in EBITDA growth."

While critics have long accused the PE industry of making money by eliminating jobs, the findings on organic growth tell a different story. "When we look at the specific claims about private equity cutting jobs, there is no evidence of that," Nicholson says. "In terms of asset-stripping, the reverse is true," he adds, explaining that PE firms tend to put more money into follow-on acquisitions than they get from selling off elements of the firms they acquire.

"It's [about] turning the business on its head and figuring out the direction they want to go," Bunder says. "It's a lot more sophisticated than just cutting costs out of the businesses, repackaging it and selling it."

Dörte Höppner, secretary general of the European Private Equity and Venture Capital Association, noted in a foreword to the European study that the value created by PE firms provides benefits beyond profits for limited partners. "To the pensioners and savers who are the ultimate beneficiaries of private equity, all returns are welcome. But it is particularly edifying to see the prominence of organic growth in driving returns. The multiplier effect of such growth across the economy benefits the whole of society."

Like most industries, private equity suffered during the recent recession, but conditions improved in 2010 and continue to trend upward in 2011.

Among the most positive signs in Europe was a significant increase in the number of exits, to 57 in 2010 from just 31 in 2009 and 32 in 2008, compared to 92 in 2007 and 100 in 2006. "One of the key drivers of this was a large increase in the number of exits via IPO," the European study summarized. "At 11, this was the highest recorded since 2006, crystallizing a large amount of value for PE."

In North America, exits jumped to 118 in 2010, compared to 76 in 2009, 51 in 2008, 109 in 2007 and 87 in 2006. These increases are due in part to an uptick in secondary buyouts, with banks loosening funding for PE firms to buy portfolio companies from one another. At the same time, in Europe there was a welcome decrease in the number of portfolio firms taken over by creditors, from 19 in 2009 to 10 in 2010. Creditor exits also fell slightly in North America.

In fact, creditor exits never reached the scale many anticipated in the depths of the recession, Nicholson says, describing the industry as "more resilient than even we expected."

In addition, creditor exits are not always as catastrophic as outsiders would think. "As with creditor exits in Europe, many of these were not insolvencies, but rather a change in equity ownership triggered by reduced but still positive business profits and prospects," the North American study found. "Overall, the exit numbers are highly encouraging in that they suggest a steady return to normality for PE that continued into the first half of 2011."

Concerns Remain

Still, conditions could be better. Among the issues for concern in Europe is the continuing absence of corporate buyers in PE exits. "Just nine (or 16%) of exits were to trade buyers, reflecting their cautious attitude towards acquisitions, well below the historical activity of three times this level," the European study noted.

In North America, trade buyers started to return to the market, accounting for half of the exits in 2010, but fell short of historical volumes. "Given the importance of trade sales as an exit route, PE exit activity will not recover fully until corporates return in full force," the North American study pointed out.

After three years of difficult conditions, sluggish exits have lifted the average holding period for portfolio companies to 4.7 years, compared to 3.7 years in the 2005-2007 period, the European study found, while the North American study put the figure at 4.4 years, the longest since the study began in 2006. Both studies noted that longer holding periods had negatively impacted internal rates of return (IRR). "IRRs are positive in 2010 but remain below the average of prior years," the North American study found.

"The passage of time really hurts," Bunder adds, noting that an aging portfolio hampers fund-raising in two ways – a lack of crystallized returns and liquidity to limited partners (LPs), as LPs are now especially concerned about seeing IRRs on older funds, and receiving distributions, before they invest again. He notes that many pension funds with troubled finances have become concerned that PE funds are so illiquid. "Not only could they not liquidate their holdings, but they received some capital calls putting additional strain on the funds."

The European study further noted that the industry "is also facing pressure to return capital to LPs, particularly where firms are likely to need to raise new funds over the next 12 to 18 months." LPs "remain highly selective and are seeking to rationalize the number of GP (general partner) relationships they maintain," the North American report added. "As a result, they have become more focused on conducting extensive due diligence and are increasingly seeking to understand how PE firms add value."

While LPs may not cut their allocation to PE, they may consolidate it into fewer funds so they can better manage their investments, Bunder says. In a tough fund-raising environment, many PE firms are looking for investors represented by sovereign wealth funds and family offices. "The challenge there is to establish a relationship and get to a point where they are comfortable investing. In addition, there could be an industry shake-out if fund-raising remains difficult over the next few years."

While it may be admirable that the industry weathered the recession as well as it did, Nicholson and Bunder caution that the environment remains challenging. The IPO market "will remain volatile for the near term" because of the choppy financial markets, Bunder says. They expect both GPs and LPs to proceed with caution, with activity continuing at about the same levels as in 2010.

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